Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:CTM:[redacted]:TL-N-6086-00
[redacted]

date: December 29, 2000

to: [redacted], Team Coordinator
LMSB Audit Group, [redacted]

from: Associate Area Counsel
LMSB, [redacted]

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subject: **Tax Treatment of Risk Withholds**
Taxpayers: [redacted]

DISCLOSURE STATEMENT

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INTRODUCTION

You have asked our advice concerning whether the position taken by the Service in regard to the tax treatment of "risk withholds," as set forth in Private Letter Ruling (PLR) 9723005, must or should be applied to the above-named taxpayers. Part of your concern in raising this issue is the taxpayers' allegations that the legal conclusions contained in the PLR are not being applied in an even-handed manner to similarly situated taxpayers, nation-wide.

As you know, the PLR was first issued as a Technical Advice Memorandum to a group of [redacted] [redacted] insurance providers, including two of the entities listed above ([redacted]), during a prior audit cycle. , (b)(7)a [redacted]
However, it is our opinion, as discussed below, that the legal analysis contained in the PLR remains well-founded. Moreover, technical advisors in Chief Counsel's National Office and the Industry Specialization Program continue to support the positions taken therein, (b)(7)a [redacted]. Accordingly, our advice is that you follow the ruling in your current audits of these (and related) taxpayers.

FACTUAL BACKGROUND

The facts and circumstances in the present case are the same as those set forth in more detail in PLR 9723005. At issue, essentially, are certain "risk withholds" and "surplus distribution payments" for which a contingent liability may arise when specific health care services are provided by contracting physicians. The services are those covered under the patients' insured health care plan with the taxpayer insurance companies (organized as health maintenance organizations, or HMOs). After performing these services, instead of requesting payment from the patient (who would then file a claim with the insurance company), the physicians, who are organized by the HMO into "preferred provider groups" (PPGs), have agreed to bill the HMO directly for these services. The physicians' maximum fees for specific services are established by agreement with the HMO, and a portion of these fees (typically 85%) are generally to be billed within 120 day after the performance of services, and paid within 30 days after billing.

The contracts provide that the remaining portion of a physician's fee will not be paid but will be entered on the HMO's books as a "risk withhold." If actual health care costs for a given PPG exceed its allocated budget goals, its "risk withholds" will be applied to the excess cost, with any remainder paid out to the participating physicians. If actual costs are equal to or less than anticipated costs, all of the "risks withholds" will be paid out. Moreover, if the actual costs for all the physicians (PPGs) participating in the HMO health care plan come within the total budget for the plan, the physicians may qualify for additional compensation ("surplus distribution payments") under terms specified by the contracts. The actual health care costs which are to be compared with the anticipated costs in determining "risk withhold" and "surplus distribution" payments are those for which services are performed during the calendar year (which is also the taxable year) and are paid in that year or within four months after the close of the year. Accordingly, the amounts, if any, which will be distributed to the participating physicians, cannot be determined until May or June of the subsequent year.

LEGAL ANALYSIS AND DISCUSSION

The taxpayers' primary position in this case has always been that the "risk withholds" and "surplus distributions" are costs incurred during the taxable year which arise out of insured events; they represent part of the contractual value of medical services provided by the affiliated physicians for insured patients. Thus, assert the taxpayers, the deduction rules of I.R.C. § 832 (under Subchapter L. Insurance Companies), which are applicable to non-life insurance companies, should apply. Pursuant to sections 832(b)(5) and 832(c)(4), estimates of these unpaid, claims-related costs were discounted by the taxpayers under section 846, then deducted as part of "losses incurred" for the year in which the services were performed.

During the technical advice process, the Service fully considered the taxpayers' arguments concerning the application of section 832, but determined that a different, more specific deduction timing rule should apply to these costs. Because the "risk withhold" and "surplus distribution" payments comprise compensation paid to the affiliated physicians for health care services rendered, the payment of which is deferred for more than a brief period of time after the end of the taxpayers' taxable year, they must be deducted under the rule of I.R.C. § 404(a)(5). This section provides that deferred compensation is deductible by the payor in the year it is includible in the gross income of the payee. Also see I.R.C. §§ 1.404(b)-1T, Q&A-1, Q&A-2(a), (b)(2) and (b)(2); 404(d) and 1.404(d)-1T. Thus, instead of being allowed to establish reserves for its anticipated "risk withhold" and "surplus distribution" costs, and to deduct such estimated costs in the year services were performed (making adjustments for over- or under-estimates in subsequent years), the taxpayers were required to deduct the actual amounts incurred when they were recognizable by the payees as income.

As discussed in the PLR, the scope of section 404 is very broad; thus, where it is applicable, the timing rules of the section take precedence over those of most other Code sections, including section 832. The intention of Congress that section 404 should apply to all types of deferred compensation was made clear when it enacted a series of amendments to the section in the mid-1980s. In addition to making it applicable to non-employee compensation, Congress expanded it by amending section 404(b)(1) to include any "method or arrangement" effecting deferral of the receipt of compensation. Also, a "clarifying amendment" was enacted which eliminated reference to I.R.C. §§ 162 and 212 in order to insure that section 404 would be applied to all forms of compensation for services, regardless of the tax provisions under which the costs might otherwise be deductible.

The taxpayers here have characterized their "risk withhold" and "surplus distribution" costs as "losses incurred," within the meaning of section 832(b)(5). Section 832(c)(4) provides that such "losses" are deductions for purposes of determining insurance company taxable income. Moreover, under the case law, extensively cited in the PLR, such "losses" have been repeatedly characterized as "deductions" for income tax purposes. Accordingly, because these costs also comprise compensation for services, the payment of which is deferred, the timing rules of section 404 must take precedence over those set out in section 832.

Compensation is "deferred," for purposes of section 404, if it is received "more than a brief period of time" after the end of the (payor's) taxable year in which the related services were performed. I.R.C. § 1.404(b)-1T, Q&A-2(a). The regulations also establish a presumption that compensation is "deferred" if it is received more than 2 1/2 months after the end of such taxable year. Section 1.404(b)-1T, Q&A-2(b)(1). This presumption may be rebutted only by a showing that it was "impracticable" to avoid deferral, and that this situation was "unforeseeable." Section 1.404(b)-1T, Q&A-2(b)(2). The taxpayers here have provided no evidence to rebut the application of the 2 1/2 month rule to the deferred payments at issue.

Since most physicians and professional corporations are cash basis taxpayers, the practical effect of applying the timing rules of section 404 to the "risk withholds" and other payments at issue is to deny deductions for most (if not all) of these costs for the year the services were performed. This is because, pursuant to contract, these costs can only be determined and paid more than 4 months after the close of the taxable year. For cost basis payees the amounts simply cannot be includible as income (and deductible to the taxpayers) until the year payment is received.

The application of section 404 to accrual basis payees is somewhat more complex, and requires a careful analysis of the facts. Based on information provided, however, it is our opinion that such taxpayers would probably not be required to recognize as income the "risk withhold" or "surplus distribution" payments due to them until the amounts to be paid, if any, can actually be calculated. The applicable tax accounting rule is the "all events" test of I.R.C.

§ 1.446-1(c)(1)(ii). This provides that "income is to be included for the taxable year in which all the events have occurred that fix the right to receive the income and the amount of the income can be determined with reasonable accuracy." The rule is repeated in I.R.C. § 1.451-1(a), which also provides that "in the case of compensation for services, if no determination can be made as to the right to such compensation or the amount thereof...the amount...is ordinarily income from the taxable year in which the determination can be made."

Here, the taxpayers' contracts with their affiliated physicians specify that the method used to calculate whether any "risk withholds" or "surplus distributions" might be due must include the costs for services paid in that year or within 4 month after the close of the year. Payments not made within this year and 4 month period will not be taken into account in determining actual costs for purposes of the "risk withhold" determinations. (b)(7)a [redacted].

(b)(7)a [redacted].

(b)(7)a [redacted]

(b)(7)a [redacted].

Moreover, although the insurance company apparently had enough information to make reserve estimates, we think it unlikely that any accrual basis physician or group of physicians would have had sufficient information available by the end of the year to allow them to calculate the amounts due to them with "reasonable accuracy"--which is the second requirement of the "all events" test. If an accrual basis payee could not have met, by the end of the year, both prongs of the "all events" test for any "risk withholds" and other payments due, the amounts would not have been includible in their gross income for that period. If so, the amounts also would not have been deductible by the taxpayers in that year.

ADDITIONAL TAXPAYER ARGUMENTS

(b)(7)a [redacted]:

1. (b)(7)a [redacted].

(b)(7)a [redacted]

(b)(7)a [redacted].

2. (b)(7)a [redacted].

(b)(7)a [redacted]

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[1] (b)(7)a [redacted].

, (b)(7)a [redacted].

3. , (b)(7)a [redacted].

(b)(7)a [redacted].

4. (b)(7)a [redacted].

(b)(7)a

[redacted].

In December 2000 technical experts on deferred compensation, Subchapter L and income tax and accounting from the Office of Chief Counsel met with Industry Specialization people from Examination, Appeals and Counsel to discuss PLR 9723005 and the application of the legal principles contained in that ruling to both insurance and non-insurance health care providers. The consensus of the group was that the Service's position, as explained in the ruling, remains well founded, and that renewed efforts will be made to apply that position in a uniform, even-handed manner, nationwide. Accordingly, our advice is that you continue to follow the ruling in your current audits.

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Attorney

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